

What Volcker really meant by 'controlled disintegration'

by David Goldman

Back in 1978, soon-to-be Federal Reserve chairman Paul Volcker endorsed the concept of "controlled disintegration" as "a legitimate objective for the 1980s," in a speech before Warwick University in England. In the light of recent events, an ordinary fellow might suspect that he was doing it on purpose:

First, the Donald Regan cabal in the White House persuaded President Reagan that he need take no action against the impact of collapsing oil prices on the U.S. economy, despite the mortal danger to the entire Southwestern banking system.

Secondly, Regan and Co. persuaded the President to rubber-stamp the April 11 dictates of the International Monetary Fund, at the May 2 Tokyo Summit, leaving the IMF as recognized referee in an international system based on multilateral cheating.

Third, Regan convinced the President to endorse tax legislation which penalizes precisely those sectors of the economy which threaten to bring down most of the international banking system.

Finally, Federal Reserve chairman Paul Volcker May 13 demanded emergency powers to arrange shotgun takeovers of failing regional banks. The undertaker, it appears, has taken extraordinary measures to increase the supply of corpses. The major money-center banks are taking advantage of the relatively faster disintegration of domestic real estate, energy, and farm debt, compared to the disintegration of their own holdings of Third World paper, to stage a takeover of the regional banking system. If they succeed, the United States will look like Britain or Canada, where a handful of megabanks have monopoly power over the financial system. This will not avert a crisis: The far-worse position of the megabanks will come to the surface in short order. It will

simply crush political opposition to whatever "solutions" the megabanks decide to employ.

Volcker's usual channel for leaks, Salomon Brothers' Henry Kaufman, indicated what sort of financial environment these people expect, in a May 6 talk before the National Press Club:

"... Strong bond performance has been weaned on lackluster economic growth. . . . This market behavior also suggests an unquantifiable speculative participation in the rally, which has undoubtedly helped to boost prices and to lower interest rates beyond levels that might have prevailed without such speculation. Wide daily price swings reflect the volume of this speculative activity. Consider the explosion in trading activity in some key sectors. The average daily volume of trading in the Treasury bond future was \$23 billion in the first four months of 1986. In the comparable periods in 1985 and 1984, this daily volume averaged only \$15 billion and \$10 billion, respectively. . . . The capacity-to leverage in the financial markets is far greater today than at any time in the past 50 years. The pleasant side of speculation is that it can reinforce a bullish trend. The dark side is that the unwinding of speculation contributes to quick, and dramatic, market reversals."

With this in mind, the Senate Banking Committee, in a special session May 13, heard the pleadings of Paul Volcker and other federal regulators, seeking emergency powers to save failing financial institutions by means of bank takeovers. The hearings occurred as two more agriculture-based banks collapsed in Idaho, bringing the number of farm-bank failures this year to 42. The emergency powers which Volcker sought in the Senate are centered on a scheme to allow takeovers of failing banks by out-of-state financial institutions—primarily Citibank and Chase Manhattan. Volcker stated,

"Banks heavily dependent on agriculture and energy have been hit particularly hard and bank failures could damage the entire economies of states and regions." He then added, "The failure of a few important institutions could raise . . . concern about others, basically sound banks, and lead to a contagious and spreading loss of confidence."

At the same hearing, Comptroller of the Currency Robert Clarke stated for the record: "There are currently 300 national banks on the problem list, up almost 300% from 1983."

The tax falls

At least 6 of the 10 largest Texas banks are represented in the Comptroller's list of 300. We reported previously that the Texas big 10 are less endangered by their energy loans, which amount to roughly 150% of shareholders' capital, than by their real-estate loans, which amount to about 500% of shareholders' capital. The washout of the Southwestern real-estate boom had already brought the proportion of delinquent loans to the level of those banks' capital, i.e., threatening their solvency. That was before the oil price collapsed.

In January, *EIR* warned that tax reform proposals formulated by the House of Representatives could knock down the value of most commercial real estate by a solid 40%, since the pricing of such properties depends heavily on tax advantages. The Packwood legislation in the Senate, supported by the White House, is actually worse than the worst-case scenario we examined at the time. It is a prescription for a real-estate market crash. Not that such a crash is not long overdue, and perhaps even beneficial under the right circumstances. But under present conditions, Packwood is in the position of the firemen in the old British wheezer, *Pure Hell at St. Trinians*, who mistakenly attach their hoses to a gasoline truck.

Both commercial and residential properties can now be written off in 19 years; the new legislation stretches this out to 27.5 years for residential properties and 31.5 years for commercial property. Depreciation would also be subject to the alternative minimum tax. Even investors who take a more active role would be limited in the amount of losses that could be claimed. Landlords could use up to only \$25,000 in losses to offset other income. That wipes out the unlimited deduction for interest expenses, which was the secret of successful real-estate speculation under the 1981 tax bill.

The designers of the tax legislation are not merely aiming at the real-estate bubble, but at the speculative bubble in all markets. Paul Volcker's recent jeremiads concerning the \$8.5 trillion in domestic debt he is responsible for creating were a crude hint to this effect. As a whole, the tax package proposes a \$22 billion tax *increase*, a classic deflationary measure, for fiscal-year 1987, due to the time gap between the elimination of tax deductions, and the phasing-in of a lower general tax rate.

Because of the elimination of the special 20% tax on capital gains, many stockholders will sell investments before July 1, 1987, to take advantage of the lower current rate.

After that, capital gains would be taxed at the ordinary income rates, which would be 15% and 27%. Regan, Volcker, et al. have called a general profit-taking.

What's next for the banking system?

Despite the recent advance in oil prices, from the \$11-12 level to the \$14-15 level, there is little hope of a price increase, for the simple reason that we are continuing our slide into depression. Gasoline demand actually fell in the United States between March and April, despite lower prices. In London May 15, the directors of Shell Oil warned stockholders at the company's annual meeting that oil prices would continue downward from the \$15 level, further reducing oil company revenues.

The stricken oil-producing regions of the country are producing little else than a wave of business failures. Tulsa's Bank of Commerce failed May 8 after panicky depositors withdrew \$5 million the previous day. Bank of Commerce's failure marked the second depositors' run against an Oklahoma bank, and this year's fourth failure. On May 1, the First National Bank of Carter became the year's third banking failure.

Oklahoma banks have lost an estimated \$200 million in capital during the past two years, even before the crashing oil price put their energy loan-paper through the shredder. The state's three largest banks are all posting losses for the first quarter of this year—even before the full impact of the oil price crash hit. Bank of Mid-America, the state's largest, showed a \$5.9 million loss; BancOklahoma showed a \$44 million loss; and First Oklahoma Bancorp projects a loss of up to \$67 million.

These are banks that have already had to scramble for cash, borrowing funds from out-of-state banks under tough conditions. First Oklahoma's capital has already fallen below the minimum agreed to with its creditors, who may now force the bank into a distress sellout.

New York buyout

In desperation, the Oklahoma State Legislature is in the process of passing a bill permitting out-of-state banks to take over failing Oklahoma institutions. The bill, supported by the state bankers' association, passed on May 7. In effect, the Wall Street mafia headed by White House chief of staff Donald Regan, the former head of Merrill Lynch, will start buying out regional institutions at garage-sale prices. Texas is the next target, where crashing oil prices and a dissolving real-estate market endanger the state's \$200 billion in banking assets.

Texas suffered another billion-dollar failure earlier this month, when Houston's Mainland Savings was shut down by regulators, and several more are expected during the next several weeks. The fallout from the Southwest banking collapse has already produced a contraction in bank lending nationally, as of the first quarter of 1986. That is the first time bank lending has contracted since the Great Depression.